PLANNING THE DISPOSITION OF PROPERTY NOT INCLUDED IN THE MARITAL DEDUCTION

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GENERAL CONSIDERATIONS

Commonly, the reasons for employing the marital deduction in an estate are compelling. The marital deduction where available and to the extent of its availability determines in large measure the plan which will be adopted. There may often be a conflict between the taxpayer's fundamental philosophy of how the property should be disposed of and the tax cost of following his view. In practice, it frequently happens that a taxpayer when faced with the tax cost of a plan which does not employ the marital deduction because of, *e.g.*, his reluctance to give to his surviving spouse the necessary control, will be persuaded to do so because of the tax savings involved. In the same way, testators who are adverse to "tying property up" over an extended period of time are persuaded to do so when they become acquainted with the sizeable tax savings that are possible. Sometimes there is a conflict between the desire to obtain greater tax savings, possible through the use of long term trusts, and the testator's objection to them as over-protecting his descendants or dependents and discouraging in them the cultivation of qualities of independence and self-reliance.

DISPOSITION OF RESIDUE TO PROVIDE FOR MINIMUM TAX ON DEATH OF SURVIVING SPOUSE

When the statute was amended in 1948 to equalize the situation in the common law states with that in the community property states by granting the marital deduction, it became the fashion for lawyers to make provision for the marital deduction and to dispose of the balance of the estate through the same techniques and methods which were in use prior to the enactment of the marital deduction. In the unusual case of the very large estate, the marital deduction, if used, would be more than an adequate provision for the wife. Normally, however, this would not be so and it would be necessary to make additional provision for the surviving spouse. A trust may be used under the terms of which she would have the right to part or all of the income, and in some cases principal, for life. This trust, consisting of the residue, which we may conveniently refer to herein as the residuary trust, would be so drawn as to avoid being included in the estate of the surviving spouse at her death. The tax would have been conceded on the marital deduction trust and an effort would be made in this fashion to avoid the tax on the residuary trust.

Since the property included in the marital deduction is required to

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be left in such a manner that it would normally be subjected to tax on the death of the surviving spouse, the next objective would be so to plan the disposition of the property in the estate of the surviving spouse as to avoid the tax on the property included in the marital deduction. This objective can in many cases be obtained by a plan under which the marital deduction trust is decreased while the residuary trust is left intact or is increased through accumulations. For example, if principal distributions are required to be made for the support of the surviving spouse in addition to the income provided for, it would be preferable to make this distribution from the marital deduction trust and the residuary trust might well provide that no distributions from principal of that trust are to be made until the marital deduction trust has been exhausted. In the extreme form, the entire income of the residuary trust would be accumulated and the distributions of principal and income made from the marital deduction trust until exhausted. Thereafter, the entire support of the surviving spouse would come from the residuary trust. In this extreme form, of course, there would be no estate tax on the death of the surviving spouse because of the limited nature of her estate in the residuary trust and the exhaustion of the marital deduction trust.

The marital deduction trust in many cases will have been drawn so as to permit the surviving spouse to dispose of the trust property during her lifetime through the exercise of a power of appointment by deed and in this manner it is possible for the surviving spouse during her life to dispose of property which would be taxable as part of her estate if passed by the exercise of a general power of appointment by will or by failure to exercise such power. Accordingly, the will or other instrument should be drawn so as to encourage the surviving spouse to avoid the tax which would apply at her death through the making of taxable gifts during her lifetime particularly if such gifts are to persons to whom she would in the ordinary course leave property by her will, *e.g.*, her lineal descendants. It is unlikely, however, that the surviving spouse would be willing to exercise an inter vivos power of appointment unless she was satisfied that the provision made for her in the residuary trust would be adequate to provide for her needs in the event she did part with a portion or even all of the marital deduction trust during her lifetime, and, accordingly, a primary requirement of the residuary trust would be to furnish her that assurance.

In the case of the will for Mr. Beaver, after the marital deduction trust, if any, has been provided for, the residuary trust will have to provide for the support of Mrs. Beaver, the daughter, Linda, and the son, Larry, the primary consideration being the support of Mrs. Beaver. With the assurance of her support being adequately provided for by the residuary trust, Mrs. Beaver would be in a position to carry out some estate planning with regard to any amounts in the marital deduction trust and the proceeds of the residuary trust would be excluded from her estate.

Long Range Planning for Period Subsequent to Death of Surviving Spouse

Once the immediate problem, namely, the minimizing of the tax on the death of the surviving spouse, has been taken care of as indicated above by those provisions in a will which complement the marital deduction, or in cases where no marital deduction is available, we approach an area of longer range tax planning in which it is difficult to be dogmatic. The form of the advisable dispositions will vary greatly with the size of the estate and with the particular family problems involved. Tax considerations are frequently secondary and the aim of the draftsman is to ensure that the taxpayer's plan of disposition can be carried out in a manner which will result in a minimum tax loss.

In approaching long range estate tax planning, some initial reflections would appear to be in order with respect to the probability of the estate tax continuing indefinitely in substantially its present form. In the last decade there has been a gradual erosion of the federal estate tax which is not entirely compensated for by the application of the tax to heretofore untaxed brackets by reason of the progressive inflation which has occurred, particularly in the period since World War II. The adoption in 1948 of the marital deduction principle, the subsequent enactment of the three-year rule on gifts in contemplation of death, and the possibility of excluding a decedent's life insurance have made the avoidance of any substantial amount of estate tax a relatively simple matter in the smaller estates. The trend may be reversed and it is entirely possible that Congress may decide upon a realistic revision of the estate tax law for the purpose of converting it into a more significant revenue raising measure, or that the increasing tempo of inflation will in effect bring about an increase in the rates.

Where the marital deduction is not involved, the simplest form of avoidance of estate tax would be the limiting of the progressive estates provided for so that the successive beneficiaries do not have those incidents of ownership which the federal estate tax law taxes. In this way the tax may be postponed for long periods, or where the ultimate descendants are numerous, may be avoided altogether.

This plan of avoidance is, of course, based on the conviction that the federal estate tax law will remain wedded to the incidents of ownership concept. Congress may some day decide to impose a tax upon the death of successive life tenants and regard the death of the person who had actually been enjoying the use of the property the occasion for the imposition of the tax. The present form of the estate tax definitely discourages the passing of outright ownership of property from one generation to the next and puts a heavy premium on the employment of trusts which with a little care and ingenuity can give each successive generation the substantial economic benefits of ownership and enjoyment of property without the attendant tax upon the termination of the interest. It would seem that any general revision of the estate tax law designed to increase the revenue raising features of the law in any substantial way would be bound to do something about the present exemption of the long term trust.

Quite apart from the significant revenue losses involved, there is also the possibility that the prevailing social philosophy may result in tax legislation which would tend to discourage the protective tying-up of the control of family fortunes by these long term trusts. If there is any growth in such sentiment, a legislative precedent is at hand in the British practice as the British rule of imposing a tax on the death of the life tenant has been in effect since 1894. The probability of the Congress adopting the British rule at the present time seems remote, but advocates of such a system have not been wanting. The existence of such sentiments in Congress and elsewhere was again brought to light in the hearings before the Subcommittee on Federal Tax Policy on Economic Growth and Stability, December 5-16, 1955. In many long term trusts it would not be wise to ignore the possibility of successive lifetime interests ultimately being subjected to a tax, and in some cases it might be desirable in the event of such legislation to terminate the trusts and to incorporate a provision which could be used by the trustee to terminate the trust in such circumstances. Such a provision in a trust would be comparable to the built-in device which destroys a space missile when it becomes evident that it will fail to orbit and would otherwise come tumbling down upon us.

Under the existing law, the temptation is very great to avoid the estate tax at the end of one generation through the use of successive life or other limited estates because of the extraordinary amount of control and flexibility which can be given to the life tenant through the use of limited powers of appointment which, in many cases, are substantially equivalent to outright ownership. As an example of such a disposition, after the provision has been made for Mrs. Beaver, the first question that must be decided is whether the shares of the children shall come to them outright, or whether their shares shall be limited to a life estate with a power of appointment. It is noted that the daughter, Linda, is married to a medical student; it is entirely possible that this student, Beaver's son-in-law, in the course of his professional life may through his skill and industry accumulate a substantial estate of his own. On his death, in the event Beaver's daughter, Linda, inherited this estate from him, or in the event he inherited all or a part of Linda's estate in the event she predeceased him, sizeable estate taxes might be incurred which could have been avoided if Beaver had initially limited Linda's share to a life estate with a limited power of appointment. In addition to the tax saving features, this plan would also have the advantage of providing for her security by preserving the principal throughout her life. In view of the size of Beaver's estate, the income from Linda's share, under normal circumstances, should protect her adequately even in the event of adversity and she could be given the right to dispose of the principal of her trust by will to her children or to her husband. The passage of these interests at her death, either through the exercise of the limited power or the failure to exercise such power, would not be taxable.

With respect to the son, Larry, age sixteen, on the basis of the information given, there would appear to be no reason to retain his share in trust beyond that point of time at which he would reasonably be expected to have attained sufficient maturity to manage his own affairs. Few parents today consider a child at twenty-one to be sufficiently mature to handle large sums of money without supervision. A plan commonly adopted would be to provide for a trust with discretionary distribution during the period of his education, or, possibly, until termination, with the principal being distributed in part at that age and the remainder at age thirty or thirty-five. Any income not needed during the period could be accumulated to be paid out to him on final distribution.

The savings in income taxes of keeping the interest of the brother and sister in separate trusts could be significant and frequently in the smaller estates the income tax savings are far more significant than the estate tax savings. In this connection, part of the benefits of accumulating income at low tax rates in a testamentary trust may be lost if the draftsman does not provide a plan for avoiding the five-year throwback rule provided for in Section 665. Disregarding the case of where the will or trust agreement was in effect as of January 1, 1954, the distribution of income accumulated after the beneficiary attains the age of twenty-one, at least to the extent that it is in excess of $2,000, would be subject to the throwback rule unless it were paid or credited to the beneficiary to meet emergency needs, or where it was distributed to the beneficiary as a final distribution made more than nine years after the date of the last transfer to such trust (Section 665(b)). It would also be possible, theoretically at least, to avoid the rule by having a sufficient number of trusts so that accumulated income would not be in excess of $2,000 in the case of any one trust.

The simplest and clearest case is the exemption in the case of the final distribution. In many cases, the final distribution would in effect be more than nine years after the creation of the trust and the problem would not arise. Where the matter of the avoidance of the five-year throwback rule is of sufficient importance, a provision postponing the time for distribution, which would otherwise take place, to the year following the ninth year would avoid the rule.